

Opportunity Zones

A Brief Introduction

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The Opportunity Zone Program

- The Opportunity Zones program was introduced as part of the Tax Cuts and Jobs Act of 2017.
- The framework for the program is included in two sections of the Internal Revenue Code:
 - Section 1400Z-1: Governed the process for designating census tracts as “qualified opportunity zones”.
 - Section 1400Z-2: Governs eligibility of investments for the tax benefits available under the program
- Proposed Treasury Regulations were released with further regulations originally expected in early 2019. Note that the federal government shutdown will likely delay this timeline.

*See: <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions>.

Public Policy Motivations

- The bipartisan think-tank, Economic Innovation Group (“EIG”)* introduced the concept of the opportunity zone to address certain ongoing economic problems:
 - Recovery from the Great Recession has been uneven, with certain areas fully recovering while other areas still suffer from high unemployment.
 - Areas that continue to struggle with high unemployment also struggle with attracting new investment.
 - Investors who have done well in the past decade want to cash out or reinvest their capital gains, but do not want to pay capital gains taxes.

*See: <https://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf>

Program Framework

- The Opportunity Zones program is an attempt to address both the underinvestment in low-income areas and investor concern about paying capital gains taxes.
 - Allows for deferral of tax on any capital gains reinvested in a “qualified opportunity fund”.
 - Qualified opportunity funds must have at least 90% of their assets invested in businesses located in any area designated as a “qualified opportunity zone”.
 - Areas designated as “qualified opportunity zones” were nominated by the governors of each U.S. state and territory.

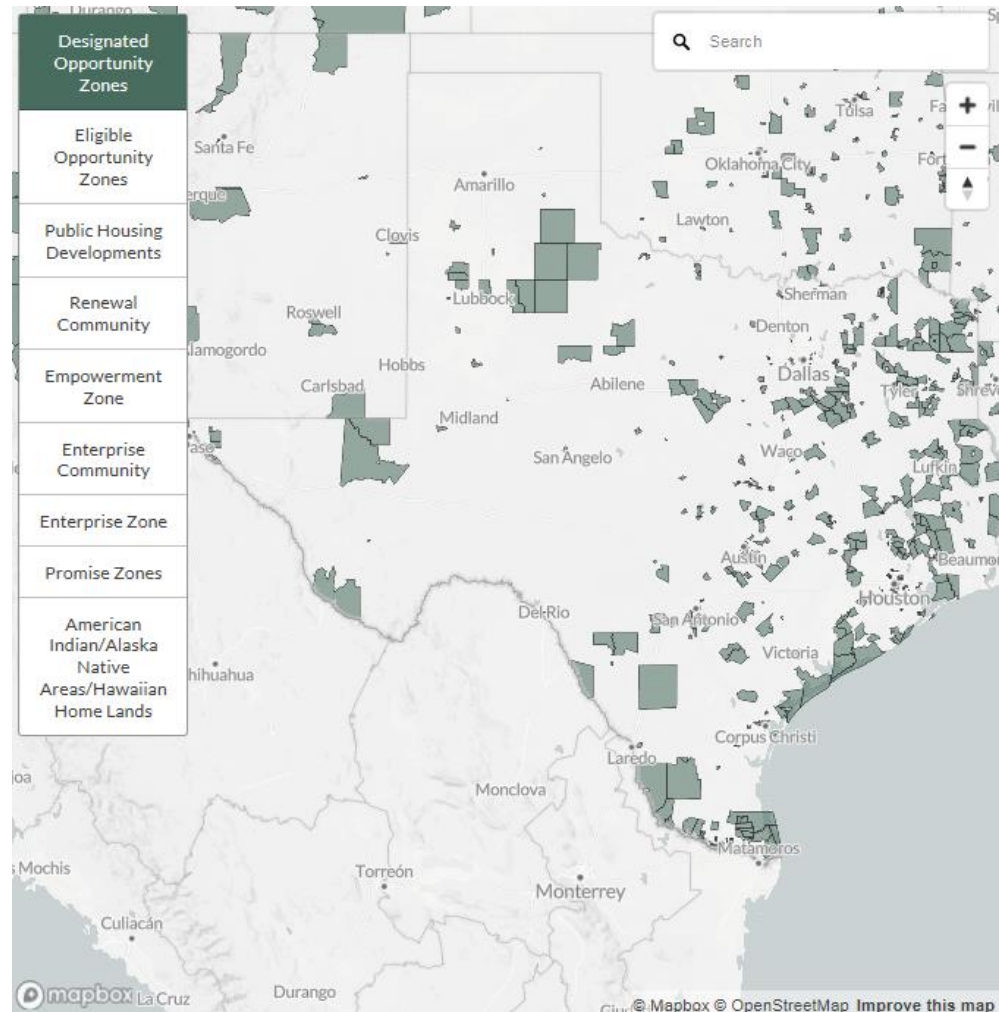
Program Framework

- The structure of the program is simple and open-ended by design:
 - Any eligible taxpayer can reinvest capital gains in a qualified opportunity fund. This includes regulated investment companies, REIT's, corporations, partnerships, LLC's and trusts and estates.
 - There is no application process for becoming a “qualified opportunity fund”. The IRS will only require a self-certification on a form to be included with the taxpayer's annual return.
 - With the exception of certain “sin businesses”, there is no restriction on what businesses a qualified opportunity fund can invest in.

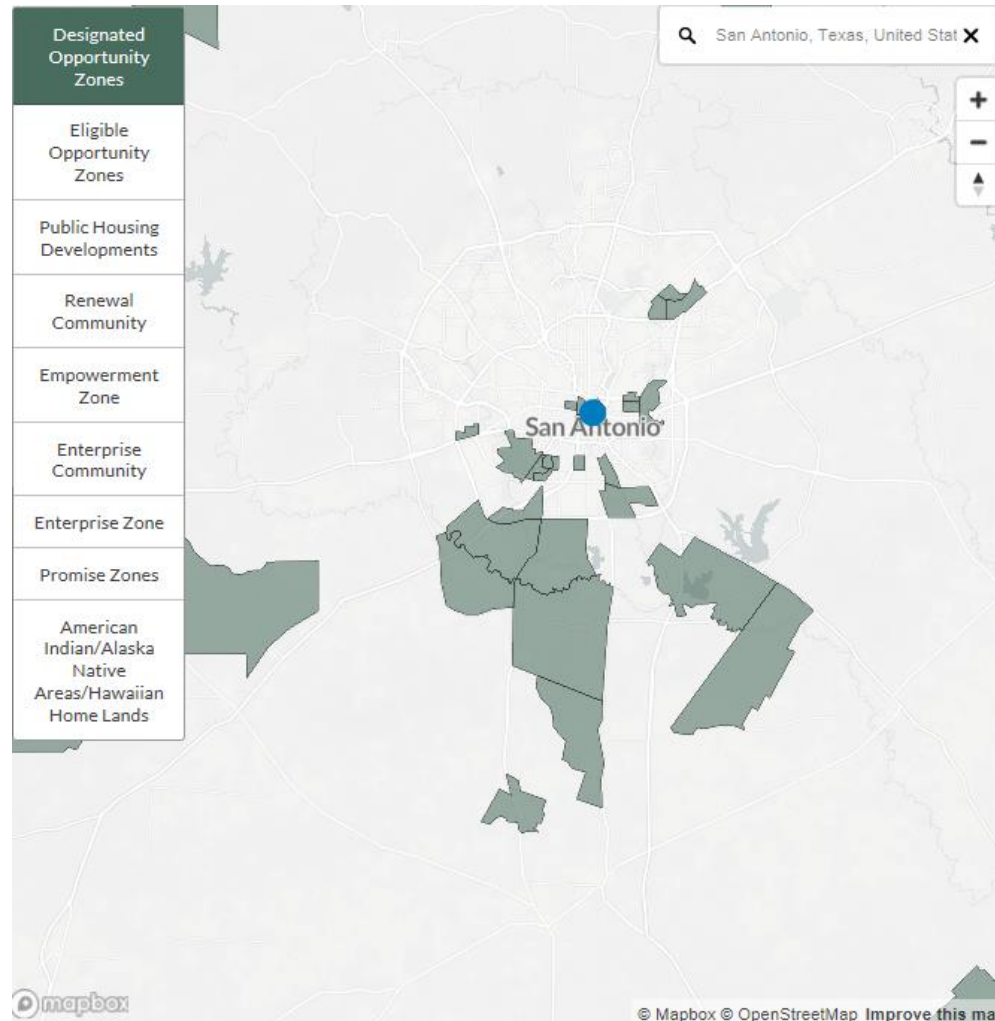
Opportunity Zone Selection

- In 2018, the governors of each state and territory nominated certain census tracts for designation by the IRS as a “qualified opportunity zone”.
- Nominated census tracts are all either “low-income communities” as defined in the Internal Revenue Code or census tracts bordering low-income communities.

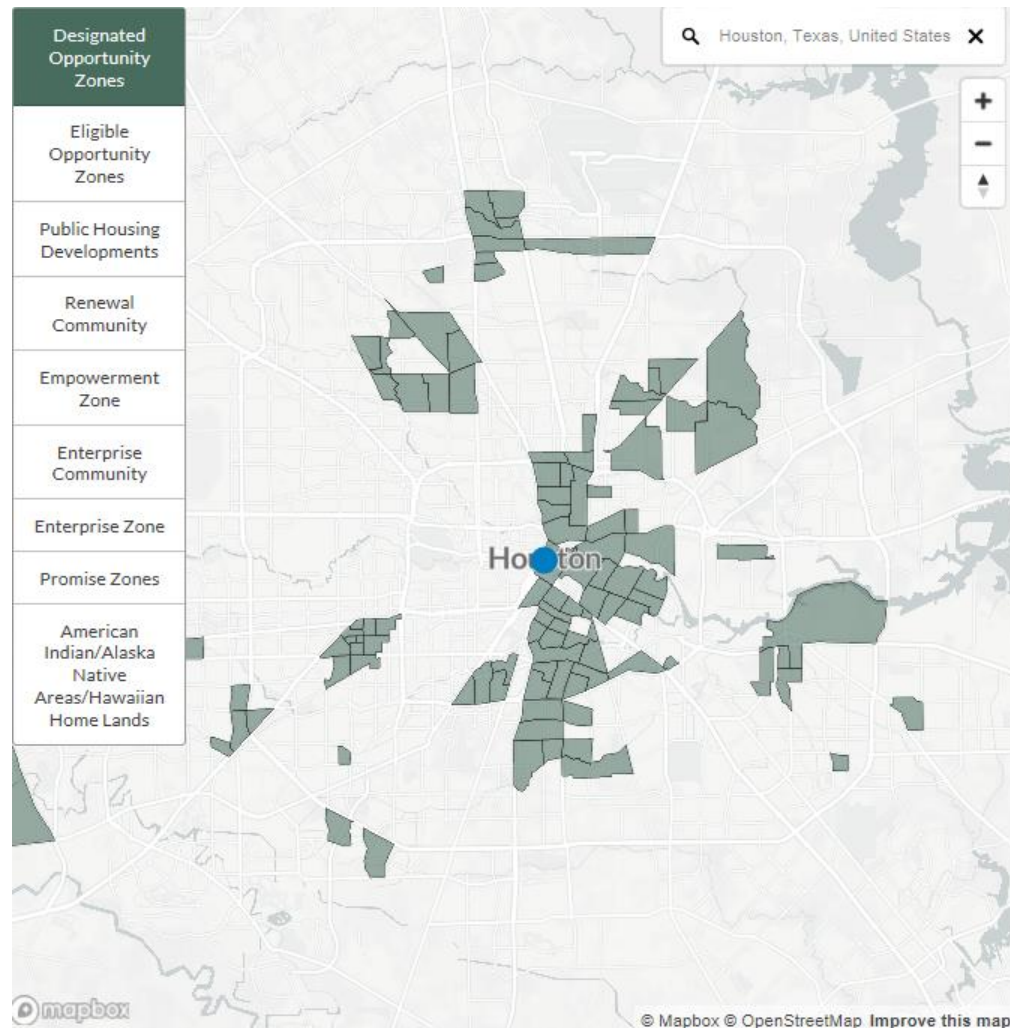
Texas Designated Opportunity Zones



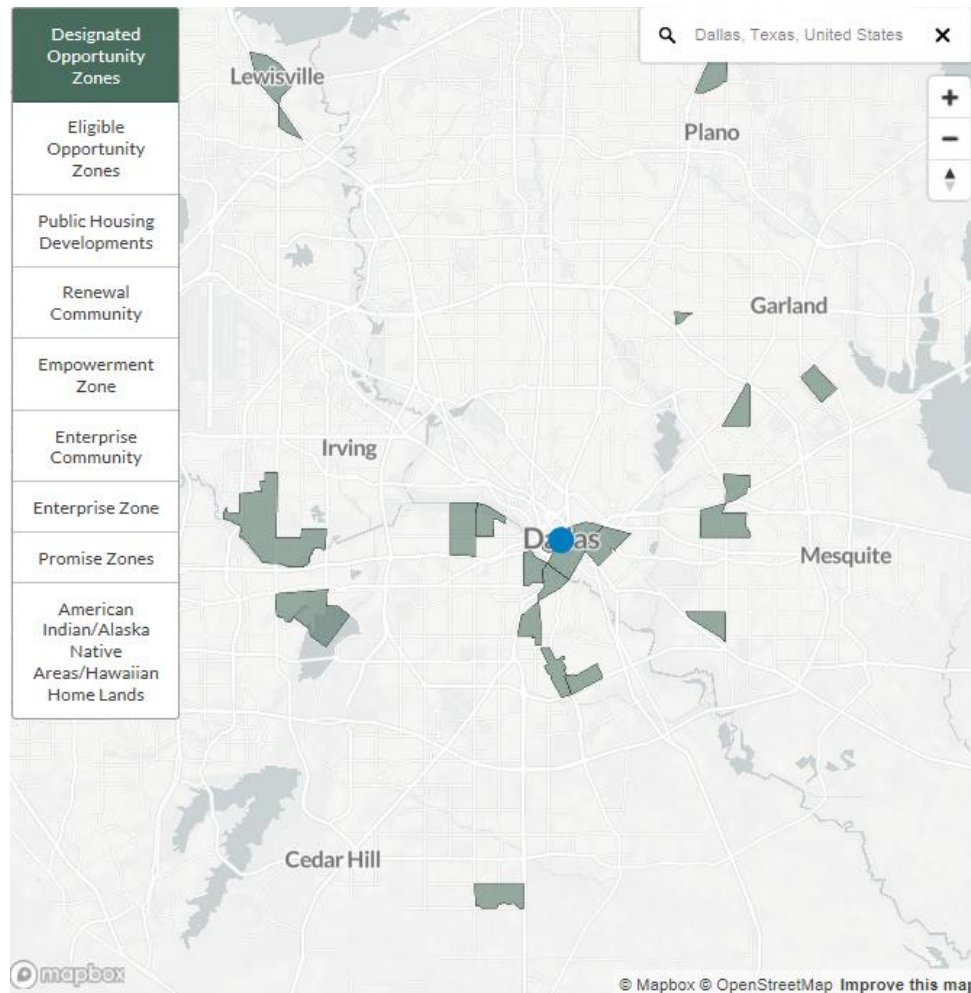
San Antonio Designated Opportunity Zones



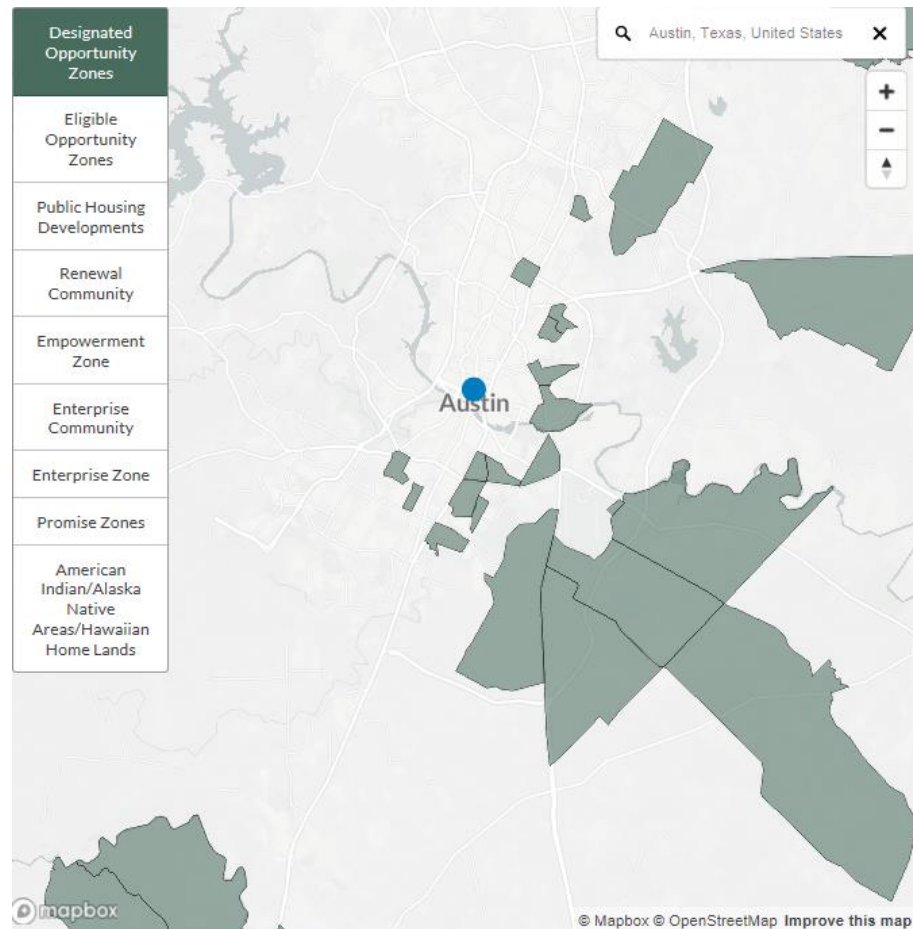
Houston Designated Opportunity Zones



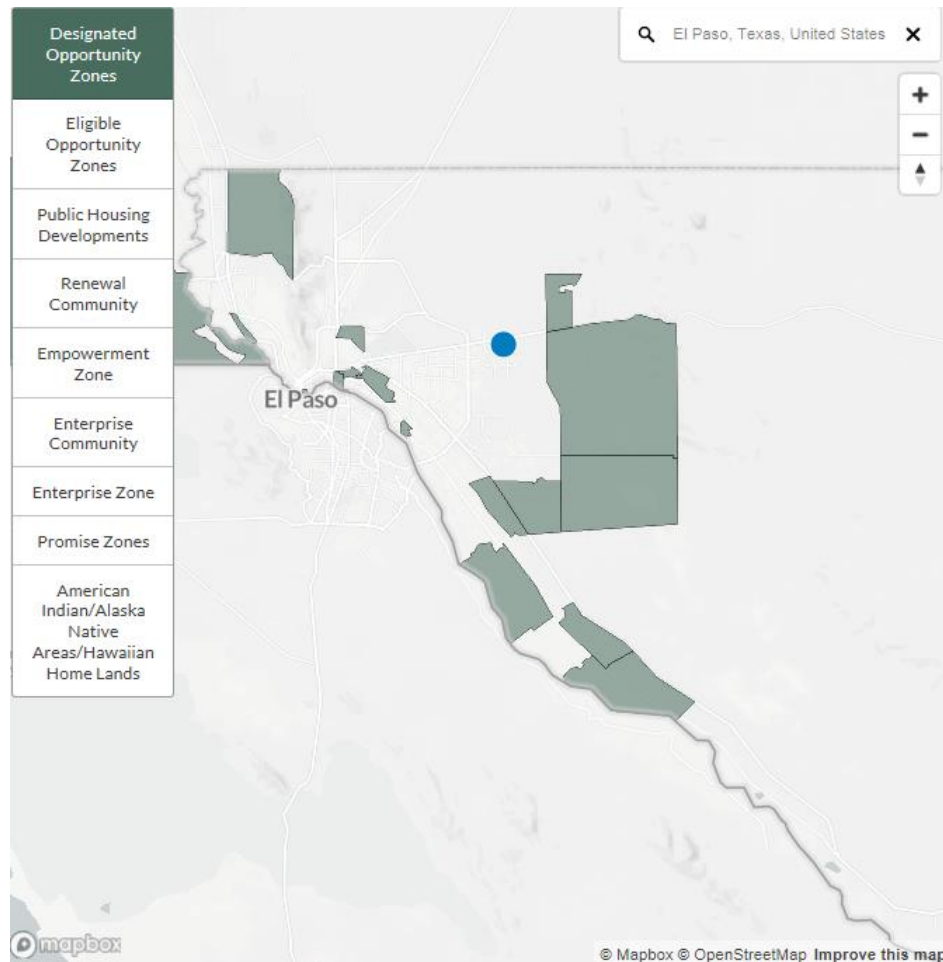
Dallas Designated Opportunity Zones



Austin Designated Opportunity Zones



El Paso Designated Opportunity Zones



“Qualified opportunity fund” defined

- “[A]ny **investment vehicle** which is **organized as a corporation or a partnership** for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least **90 percent of its assets in qualified opportunity zone property**, determined by the average of the percentage of qualified opportunity zone property held in the fund as measured on the last day of the first 6-month period of the taxable year of the fund, and on the last day of the taxable year of the fund.”

Qualified Opportunity Zone Property

- 90% of a qualified opportunity fund's assets must be “qualified opportunity zone property”. This can take two forms:
 - Direct ownership of tangible property owned or leased by the taxpayer is used in a trade or business located in an opportunity zone.
 - Ownership interest in a corporation or partnership in which at least 70% of the tangible property owned or leased by the taxpayer is used in a trade or business located in an opportunity zone.
 - The “original use” or “substantial improvement” of the property must result from the qualified opportunity fund investment.
 - In practical terms, “substantial improvement” means spending on improvements to an asset at least what you paid to acquire it.
- Ownership of most brick-and-mortar businesses operating within an opportunity zone will satisfy this test.

Making a Qualified Opportunity Fund Investment

- When a taxpayer sells an investment that results in a capital gain, the taxpayer can defer tax on any portion of the capital gain that is reinvested in a “qualified opportunity fund”
 - Investment in a qualified opportunity fund must take place within 180 days of the day that the capital gain occurred.
- Tax on the reinvested capital gain is deferred until the later of:
 - The sale of the qualified opportunity fund investment; or
 - December 31, 2026
- Partial capital gains tax forgiveness for long-term investments:
 - If a qualified opportunity fund investment is held for at least 5 years, capital gains tax is reduced by 10%.
 - If a qualified opportunity fund investment is held for at least 7 years, capital gains tax is reduced by an additional 5%, for a total reduction of 15%.
- No capital gains tax on the qualified opportunity fund investment itself if it is held for at least 10 years.

Example Investment

- 7/1/2019: OZ, Inc.. sells certain investments that result in a capital gain of \$1,000,000. All or a portion of capital gain must be reinvested by 12/28/2018.
- 12/1/2019: OZ, Inc. invests all of its gain in an qualified opportunity fund.
- 12/1/2024: OZ, Inc. has held its investment for five years. As a result, \$100,000 of the original \$1,000,000 capital gain will not be taxed.
- 12/1/2026: OZ, Inc. has held its investment for seven years. As a result, an additional \$50,000 (\$150,000 total) of the original \$1,000,000 capital gain will not be taxed.
- 12/31/2026: OZ, Inc. must recognize \$850,000 in capital gain .
- 12/1/2029: OZ, Inc.'s has appreciated to a total value of \$2,000,000. However, because it has held its investment for at least 10 years, it will not have to pay any capital gains tax on the appreciation of its investment when it is sold.

Timing Issues to Anticipate

- Capital gains tax that is deferred must be recognized by no later than December 31, 2026:
 - If you want to keep your capital gains in your opportunity zone investment past this date, ***you need to make sure you have other sources with which to pay the deferred capital gains tax.***
 - To take advantage of the maximum possible forgiveness of capital gains tax, you must make invest in an a qualified opportunity fund by December 31, 2019..
- The 180-day requirement to reinvest capital gains also creates timing issues that need to be managed:
 - A qualified opportunity fund investment should be identified prior to making a sale that results in capital gain to ensure that any gains can be reinvested within 180 days.
 - Installment-based equity investments will be difficult.

October 19 Guidance

- On October 19, the Department of Treasury released an IRS revenue ruling and proposed rules governing. Highlights of the Proposed Regulations:
 - Cash can be held as “working capital” for up to 31 months and be considered qualified opportunity zone property for purposes of the 90% test. This is important for long-term rehabilitations.
 - In the case of any acquisition of real estate assets, whether a “substantial improvement” took place will be determined based on the portion of the purchase price that does not include the land.
 - Only gains that are considered capital gains for federal income tax purposes can be deferred when reinvested in a qualified opportunity fund.

Questions still remain...

- While we have started to get answers to some initial questions, the Department of Treasury has advised that it will provide additional guidance on the following topics:
 - How much time will a qualified opportunity fund have to make deploy funds it receives from investors?
 - If a qualified opportunity fund accumulates capital gains of its own, how will those gains be treated if reinvested?
 - Will any safe harbors be available to protect qualified opportunity funds if improvements to a property are delayed for reasons outside of its control? (e.g. rehab of a property is delayed due to a natural disaster)

Coming Attractions

- An additional set of proposed regulations is expected to be released in early 2019 covering certain topics that were not discussed in the October 19 release.
- Additional revenue rulings and informal guidance are expected to be released on an ad hoc basis as needed.
- At least two bills have been introduced in the Texas Legislature, introducing a state-level opportunity zones benefit.

Thank you



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